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EXCHANGE-TRADED FUNDS

A More Active Role

Mutual funds, beware: ETFs increasingly are moving beyond indexes

By DAISY MAXEY

The exchange-traded-fund industry's attack on the mutual-fund world is intensifying.

Just over a year after Invesco Ltd.'s Invesco PowerShares Capital Management unit began selling ETFs unhinged from indexes and run by managers who select stocks, a few other firms have entered the fray and more are poised to join them.

The next few years promise to bring tremendous innovation to the marketplace as some of the biggest names in the mutual-fund world—among them Allianz SE's Pacific Investment Management Co., State Street Corp.'s State Street Global Advisors and Vanguard Group Inc.—seek permission from the Securities and Exchange Commission to offer actively managed ETFs.

"The trend has been pretty clear," says Don Suskind , head of the ETF product-management team at Pacific Investment Management, known as Pimco. "ETFs have grown, and they have become increasingly important."

ETFs are baskets of securities that trade like individual stocks and so far have generally tracked indexes. Their structures generally offer cost and tax advantages over most conventional mutual funds, as well as additional transparency because they disclose their holdings daily.

In April 2008, PowerShares launched PowerShares Active Low Duration, an actively managed bond ETF, along with three actively managed stock ETFs: PowerShares Active Alpha Multi Cap, PowerShares Active AlphaQ and PowerShares Active Mega Cap. In November, it launched PowerShares Active U.S. Real Estate.

The ETFs were billed as the first stock ETFs that, instead of precisely tracking indexes, gave managers leeway to choose portfolio holdings. (Bear Stearns Cos. launched what is considered the first actively managed bond ETF; it closed after the investment bank collapsed last year.) It took the ETF industry almost 10 years to win regulatory approval for these actively managed funds.

The combined amount under management at the five PowerShares funds is small, at $21.4 million. That isn't

a surprise to Ed McRedmond, senior vice president of portfolio strategies at Invesco PowerShares, who says the firm didn't expect the actively managed ETFs to grab huge amounts of territory from traditional mutual-fund firms overnight.

"We never expected that active ETFs would be the Holy Grail," says Mr. McRedmond. Rather, the firm anticipated that their introduction would be a "slow, educational" process in which PowerShares would have to show that the products could maintain the low-cost and tax advantages of the ETF structure, he says.

The three pioneering stock ETFs have had widely varying results so far. Active Mega Cap is well ahead of the Standard & Poor's 500-stock index for the 12 months through June 30, Active AlphaQ is in a dead heat, and Active Alpha Multi Cap is lagging behind the S&P 500 as well as a broader market index that PowerShares uses for comparison purposes. The three ETFs carry a 0.75%-of-assets annual expense ratio, compared with 1.36% for the average U.S.-stock mutual fund, according to Morningstar Inc.

The Disclosure Dilemma

There is no question that ordinary investors have a lot to digest as ETFs move beyond indexes. The basic ETF structure is complicated enough: In simplest terms, ETFs are created when securities firms or specialists assemble baskets of stocks or bonds that resemble an ETF's underlying, published index. They exchange their baskets with the fund for ETF shares, which they can hold or sell to other investors, via a stock exchange.

In contrast, a conventional mutual fund takes cash directly from investors, issues fund shares to the newcomers and puts the money to work.

The challenge in moving beyond indexes is that stock pickers usually are loath to frequently reveal their holdings. That's because it can inspire copycats to jump into the market with similar trades as positions are being built up or eliminated, moving the stock price. Mutual funds usually disclose holdings only once a quarter or once every six months.

So how does an ETF stock picker build positions and keep market makers in the loop while avoiding front-runners?

In general, most of the actively managed stock ETFs on the market are focused on big, heavily traded stocks, which are the least susceptible to the adverse price movements that copycats can cause.

Another approach is using multiple managers. Some would-be copycats seek to mimic the moves of a particular manager whom they regard as savvy. If an ETF is run by multiple managers, the copycats wouldn't know which of the managers is behind a move that pops up on a disclosure list, so they may be less inclined to copy it.

Grail Advisors LLC's Grail American Beacon Large Cap Value ETF, which launched in May, is sub-advised by American Beacon Advisors Inc. and allocates investors' money among Brandywine Global Investment Management LLC, Hotchkis & Wiley Capital Management LLC and Metropolitan West Capital Management LLC.

"We see every day what the fund owns, but there are three managers so we don't know who owns what," says Scott Burns, director of ETF analysis at Morningstar. "It alleviates the front-running concerns."

Single Managers

Grail hopes to introduce an actively managed international, large-stock ETF in mid-to-late July, and by Sept. 1 it aims to launch four ETFs with a single manager at each one's helm actively picking stocks.

New York-based RiverPark Advisors LLC will be the primary sub-adviser for each of the four ETFs: RP Growth, RP Focused Large Cap Growth, RP Technology and RP Financials. Wedgewood Partners Inc., of St. Louis, will also sub-advise the focused large-cap fund.

Morty Schaja, RiverPark's chief executive, says he is comfortable with full disclosure of holdings on a daily basis. Large institutional clients, such as pension funds, have always demanded disclosure of their investments, he says.

Front running isn't a concern, he says, because the ETFs will invest in midsize to large stocks. "At least up to the point that we have billions and billions [invested] in these ETFs, there is going to be infinite liquidity to establish our positions [in a single day], if we want to do that," he says.

Meanwhile, Grail is in discussions with several investment-management firms about potentially converting conventional mutual funds to ETFs, says Grail Chief Executive William Thomas.

Claymore Securities Inc. has been waiting two years for approval from the SEC to launch an actively managed "nontransparent" stock ETF. The Lisle, Ill., firm has been working with the New York Stock Exchange to license proprietary technology to address trading-disclosure issues, says Christian Magoon, Claymore's president.

Its concept is a portfolio that both owns stocks and makes bearish bets on stocks, all of them part of an index tracked by the ETF. Claymore would reveal a basket of securities with the same risk and return characteristics as the ETF's portfolio, without disclosing the ETF's actual portfolio holdings.

"If we put an active manager with a great track record in an active ETF, then they can compete on an apples-to-apples level" with traditional funds, Mr. Magoon says.

Battle Heats Up

Vanguard, a giant in both indexed mutual funds and ETFs, has filed with the SEC to launch four actively managed ETFs that would be connected to existing bond funds. "The active ETF space remains a very large question mark," says Martha Papariello, head of Vanguard's Financial Advisor Services unit. If true actively managed stock and bond ETFs can be created, it "could lead to substantial additional products in the industry," she says.

Another potential big player in the field is giant money manager BlackRock Inc., which is buying Barclays PLC's Barclays Global Investors unit with its iShares ETF business. "We will explore the viability and suitability and pursue product ideas," Rob Fairbairn, a BlackRock executive, says, noting that "there are still product-design and regulatory hurdles to overcome."

Doug Dannemiller, a senior analyst with Aite Group LLC, a Boston research and consulting firm, is among those expecting activity to continue heating up. "The battle for investors' assets between mutual funds and ETFs has heated up," he says. "ETFs are on the offensive."

Still, it will take longer track records and strong sales networks to make actively managed ETFs a force, says Morningstar's Mr. Burns. But "four or five years down the road," he says, there likely will be sufficient evolution so that investors will be "indifferent to the wrapper"—mutual fund or ETF—that an investment strategy is in.

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